No. 15752

United States Court of Appeals

For the Ninth Circuit

MATHEW J. SPIESMAN, JR., AND MARY SPIESMAN,
Petitoners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeal from the Tax Court of the United States

BRIEF FOR PETITIONERS

PAUL CASTOLDI,
FRANCIS J. BUTLER,
811 Paulsen Building,
Spokane 1, Washington,
Attorneys for Petitioners.

THE FRANKLIN PRESS, SPOKANE

No. 15752

United States Court of Appeals

For the Ninth Circuit

MATHEW J. SPIESMAN, JR., AND MARY SPIESMAN,
Petitoners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeal from the Tax Court of the United States

BRIEF FOR PETITIONERS

PAUL CASTOLDI,
FRANCIS J. BUTLER,
811 Paulsen Building,
Spokane 1, Washington,
Attorneys for Petitioners.

THE FRANKLIN PRESS, SPOKANE

INDEX

TABLE OF CASES

STATUTES

OTHER AUTHORITIES CITED

INDEX OF EXHIBITS

United States Court of Appeals
For the Ninth Circuit

MATHEW J. SPIESMAN, JR., AND MARY SPIESMAN, *Petitioners,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 15752

Appeal from the Tax Court of the United States

BRIEF FOR PETITIONERS

JURISDICTIONAL STATEMENT

The Tax Court of the United States, in a written opinion reviewed by the full Court (28 T.C. No. 62), held adversely to Petitioners herein under date of May 31, 1957. The decision of the Tax Court of the United States was entered June 4, 1957. An order amending the said decision was entered August 27, 1957. Petitioners herein filed a Petition for Review with the Circuit Court of Appeals for the Ninth Circuit on the 30th day of August, 1957. A copy of said Petition together with a Notice of Filing Petition for Review was filed with the Chief Counsel, Internal Revenue Service, Washington, D. C. The returns for the periods here involved were filed with the District Director of Internal Revenue for the State of Idaho.

This Court has jurisdiction on appeal from the decision of the Tax Court of the United States by virtue of Section 7482 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE

The question involved in this proceeding is the validity of the family partnership entered into between Petitioner Mathew J. Spiesman, Jr., his five children, and his father. The taxable years involved are the years 1951 and 1952. The Tax Court of the United States held that the said partnership was invalid.

Mathew J. Spiesman, Jr., Petitioner herein (Mrs. Mathew J. Spiesman, Jr., Mary Spiesman is a petitioner in this proceeding only by virtue of filing a joint income tax return for the taxable years involved with her husband. For the sake of convenience, reference to Petitioner will be used in the singular since Mathew J. Spiesman, Jr., is the principal party included in the discussion of the case) returned to St. Maries, Idaho, upon the death of his mother in 1937. At that time he evidenced a desire to retire from professional baseball. Mathew J. Spiesman, Sr. (sometimes referred to as Petitioner's father), who at the time of the hearing in this case was eighty years old, had retired from business some time in 1935. Petitioner's father established Petitioner in business by advancing the money with which the Petitioner purchased a one-half interest in his father's old business and formed a partnership for the conduct of a bar with one Resor.

In February of 1950, prior to the taxable years involved herein, Petitioner and his father formed a partnership known as Spiesman & Spiesman. Prior to the formation of this partnership, Petitioner had

owned several slot machines and other coin-operated amusement devices. Petitioner's father purchased a one-half interest in these machines and other coin-operated amusement devices and they thereupon transferred the same to the Spiesman & Spiesman partnership. Petitioner also transferred to the partnership an agreement which Petitioner had with the Gem State Club, a corporation of which he was president. The agreement with the Gem State Club was that the machines and other coin-operated amusement devices would be left on the premises of the Gem State Club for operation and the Petitioner would maintain the machines and receive for service and rental 20 per cent of the total receipts. This agreement covered all coin-operated amusement devices. Spiesman & Spiesman operated under this agreement until December of 1951. The partnership of Spiesman & Spiesman, although somewhat material to a discussion of the facts herein, is not in any way involved in this controversy.

Some time in October of 1951, Petitioner's father read an article in the U. S. News and World Report entitled "Partnership Within the Family May Save Tax." The article was an explanation of the changes made by Congress in the 1951 Revenue law liberalizing the rules governing the taxation of so-called "family partnerships."

Petitioner at this time was the father of five children who were born on the following dates:

Name	*Date of Birth*
Michael Joseph	October 21, 1940
Philip James	November 29, 1943
Leonard John	February 11, 1945
Mathew James III	July 3, 1946
Francis Edward	September 26, 1950

Petitioner's father a number of years earlier had embarked upon a program of gifts to Petitioner and to his five children. The purpose of the gifts were to avoid the legal work upon probate. Petitioner's father attempted over a period of years, beginning in 1945, to equalize the gifts among the children and provided for future equalization in his will.

Petitioner's father, based upon information gleaned from the article in the U. S. News and World Report, referred to above, suggested the possibility to Petitioner of a so-called family partnership. Petitioner, after listening to his father and reading the article in the U. S. World Report, was not certain. Petitioner, however, at his father's insistance, took a trip to Boise, Idaho, and consulted an attorney concerning the legal aspects of the so-called family partnership form of doing business under the changes that had been made in the law in 1951. The attorney being unable to answer the question, directed the Petitioner to the Internal Revenue Service office for information. The Internal Revenue Service informed Petitioner that they were not in a position to give him

a ruling or any advice as to the validity of the family partnership under the new law, but called to his attention the provisions of the law which were then applicable (Section 191 and Section 3797(a)(2) of the Internal Revenue Code of 1939 as amended by Section 340(a) and (b) of the Internal Revenue Act of 1951). Petitioner took the quoted sections which had been offered him by the Internal Revenue Service and returned to the lawyer, who after having read the sections informed the Petitioner that under the circumstances a family partnership would be perfectly legal. At this time the Petitioner informed the attorney that the partnership would be in the con-operated amusement device business.

Under date of December 1, 1951, Petitioner's father, and Petitioner's five children formed a new partnership known as Spiesman & Sons. It is the validity of this partnership which is the cause of the interest in controversy.

In the formation of a new partnership Spiesman & Sons, Petitioner's father gave to each child a proportionate share of all but one-ninth of his interest in the equipment and/or his parnership interest, of the partnership Spiesman & Spiesman; Petitioner gave the children all but one-third of his interest so that the partnership was owned six-ninths by Petitioner's father and Petitioner's five children (each party owning one-ninth), and three-ninths by Petitioner and his wife. There is no question that the

partnership income tax returns for the two taxable years involved herein reflect this distributive share of partnership income.

The income from Spiesman & Sons came from the 20 per cent of the receipts received under the leasing agreement that Petitioner had with the Gem State Club and which Petitioner had assigned to the new partnership. At the end of 1951, and again in 1952, the income was allocated among the partners according to their interest in the partnership. The partnership information returns reflect such distribution. The money which was allocated to each child based upon his distributive share found its way into one of four places: The money was placed in Merchants Bank of Rockford, Washington; or used to buy securities for the children; or used to pay the income taxes of the children; or used to pay insurance premiums of the children. In subsequent years, some of the money ($500) was also used as an additional contribution to capital of the partnership when such additional capital became necessary when the Supreme Court of the State of Idaho held that coin-operated amusement devices violated the state constitution. However, during the taxable years involved herein, the machines were legal under Idaho State law. None of the amounts were expended in any way for the support of the children.

Petitioner was appointed guardian for his four oldest children on April 17, 1947. Letters of guardianship were issued in the Probate Court of Benewah

County, State of Idaho. Letters of guardianship were issued for Francis Edward Spiesman, Petitioner's youngest son, under date of October 13, 1953. Petitioner was appointed guardian of the four oldest children at the request of the Bunker Hill and Sullivan Mining Company, who made such request so that the dividend checks which were issued to the children could be cashed by their father. The Bunker Hill and Sullivan Mining stock and other stocks had been transferred to the children as a gift by their grandfather prior to the formation of any of the partnerships involved herein. During the early years of the guardianship, Petitioner had purchased bonds and other stocks and put them in the name of each child without himself being named as co-owner. All the funds collected by the Petitioner were held or expended for the children.

At the time the Internal Revenue Service started their investigation, Petitioner had not filed an inventory and accounting for said guardianship. Prior to this time he had not been advised to do so or advised of the necessity to do so by his attorney. At the suggestion of the probate judge in Benewah County, the Petitioner did file an inventory and accounting for the said children. The first inventory and accounting filed was under date of October 23, 1953, and covered the years 1947 through December 31, 1952. Subsequent to this, accountings were filed for each of the years 1953, 1954 and 1955. The Probate Court of Benewah County issued an order settling the inventory and account and report of guardian under date

of November 12, 1953. At that time, all of the actions of the guardian were given court sanction. The Court said:

> "And the Court having examined the said beginning inventories with respect to each of the said wards and the Court having further examined the subsequent annual inventory and accountings filed by said guardian, and it appearing to the court that all the statements in said inventories as filed by said guardian are true and correct, and that the subsequent accountings were true and correct, and it further appearing to the court that the administration of said guardianship of said minor wards has been regular and proper and has been conducted to the best interests of said minor wards,
>
> "IT IS, THEREFORE, ORDERED, ADJUDGED AND DECREED that the said inventories heretofore filed by the said M. J. Spiesman, Jr., setting out the assets which were acquired by the said guardian at the inception of said guardianship, be and the same are hereby approved, allowed and settled."

During the years involved herein in which the partnership was also involved (taxable years 1951 and 1952), the Petitioner as guardian withdrew unequal amounts from the partnership and deposited these amounts to the respective account of each child. However, during this period, the partnership returns filed on behalf of the partnership, showed an equal distribution of income and the children of the Petitioner filed income tax returns reflecting this amount. This

unequal withdrawal was done at Petitioner's own volition in an effort to equalize cash accounts. Subsequent to this time Petitioner, after noting his mistake, evened the unequal withdrawals and (though the partnership is still in existence), the record indicates that each child has substantially equal amounts in the savings account as of 1956.

The Internal Revenue Service assessed deficiencies against Petitioner for each of the taxable years 1951 and 1952 based on the theory that the so-called family partnership was invalid. In so doing, the Government took *all* of the partnership income allocable to the children and taxed it back to the Petitioner. No effort was made to tax any of the income allocable to the children to the Petitioner's father who had made the gifts to the children in the first instance. The Government's theory of the case set out in the statutory notice of deficiency said simply the following:

> "That the earnings of the business, Spiesman & Sons, are primarily attributable to the services of Mathew J. Spiesman, Jr., and your capital contribution; and further, that to no substantial extent are such earnings attributable to either capital or services of any of said minor children."

The identical language is used in the statutory notice for both taxable years involved herein.

The Petitioner at the hearing in his opening statement set forth as his basic contention the family partnership and as an alternative the fact that the income of the children had not been taxed back to the Petitioner's

father instead of Petitioner. The Internal Revenue Service maintained: that the interest of the children in the partnership didn't coincide with tests laid down in Treasury Regulations 118.39.191(B)(8); that the Idaho law prevented the child from owning any interest in coin-operated machines, and lastly that "to no substantial extent are the earnings of the business attributable to either capital or services of the five minor children."

The Tax Court of the United States in its opinion (28 TC No. 62) found as a fact that capital was an income-producing factor of the Spiesman & Sons partnership; that the salary paid to Mathew J. Spiesman, Jr., by the partnership was reasonable; that amounts were withdrawn from the partnership on behalf of the children; that of the funds so withdrawn, some were deposited in savings accounts for the children; some were used to pay premiums on the children's life insurance, taxes, and to purchase securities for them. Ultimately, however, the Court found as a fact that the interests of the five minor children in the Spiesman & Sons partnership were not bona fide during the taxable years 1951 and 1952. The reasoning of the Tax Court is not clear but the crux of the opinion is well set forth in the following excerpt from said opinion: "We think it clear that there were no bona fide gifts of interest in the machines, which were the income-producing assets of the partnership, to the children, and the formation of the Spiesman & Sons partnership was a *sham*." (Emphasis supplied.) The Tax Court of the United States erred in so holding.

If the facts of record prior, during and subsequent to the formation of the family partnership involved herein are considered in the light of the changes made by Congress in Sec. 340(a) and (b) of the Revenue Act of 1951 and under the arguments set forth herein, the partnership Spiesman & Sons was a valid partnership for income tax purposes.

SPECIFICATIONS OF ERROR

I

The Tax Court of the United States erred in is finding that the partnership Spiesman & Sons was not a valid family partnership for federal income tax purposes since it failed, in so finding, to give full import to Section 340(a) and (b) of the Revenue Act of 1951, which said section changed the law regarding the taxation of family partnerships, and because the facts of record would not justify the specific holding that the said partnership was a sham.

II

The Tax Court of the United States erred in their interpretation of the facts upon which they relied in making their ultimate finding that the partnership Spiesman & Sons was not a valid family partnership for income tax purposes for the taxable years 1950 and 1951. Specifically, the Tax Court erred:

(a) In placing any reliance upon the partnership agreement and the interlineations appearing therein because the said agreement, as augmented by oral testimony, represents the true intention of the parties and

contains no limitations upon the distribution of income or other limitations which would preclude a finding that the partnership was valid for federal income tax purposes;

(b) In relying upon the partnership income tax returns of Spiesman & Sons for the taxable years included herein, in determining the ownership of the coin-operated amusement devices because the capital accounts contained in the schedules in the said partnership return are erroneous based upon the admitted facts of record, and further that the unequal withdrawals of the children are immaterial since it is the undisputed equal distribution of partnership income which each said minor received from the partnership and, which is reflected in the said tax returns, which is material and determinative for federal income tax purposes;

(c) In not recognizing that the guardianship inventory and accounting reports as filed by Petitioner on behalf of the said minor children, though filed late, were nonetheless indicative of the fact that the partnership and the distribution of partnership income was valid since the said accountings established that Petitioner never used any of the money for his own purpose and since the said reports were approved in every way by the State Court;

(d) In relying upon the rationale of the *Culbertson* case since that case was specifcally overruled or limited by the Revenue Act of 1951 which governs this proceeding.

III

The Tax Court of the United States erred in placing any reliance upon the following facts in making their ultimate determination that the partnership Spiesman & Sons was invalid for federal income tax purposes:

(a) The partnership accounting since if this is to be a factor, the finding of the Probate Judge of Idaho supports the validity of the partnership;

(b) The Idaho law since said law is not controlling in the instant case but if controlling on the validity of the partnership, is a further factor in substantiating the Petitioner's contention herein;

(c) The Tax Court case of *E. C. Ellery,* since that opinion is not factually compatible with the instant case.

IV

The Tax Court of the United States erred in holding that the entire income of the minor children in the partnership Spiesman & Sons should be taxed to the Petitioner, herein, rather than allocating the income back to Petitioner and Petitioner's father in proportion to the original gifts made herein.

INTRODUCTION TO ARGUMENT

The instant case involves the oft litigated, much written about question of the validity of a family partnership for federal income tax purposes. Its only

claim to significance is found in the fact that this is apparently the first Tax Court holding under the statutes which Congress enacted in 1951 which were intended to *liberalize* the whole law pertaining to the federal taxation of family partnerships. The history of the question needs no comment. The names *Tower* (*Commissioner v. Tower,* 327 U. S. 280) and *Culbertson* (*Commissioner v. Culbertson,* 337 U. S. 733), need no introduction. Suffice to say, that the Internal Revenue Service and the courts in general found uncertainty in the wake of the Supreme Court's decision in the *Culbertson* case. The courts were crowded with family partnership disputes and the taxpayers were left to ponder the question of whether their partnership device would be recognized under the various tests promulgated by the courts and the Internal Revenue Service. The whole state of the law was dependent upon so many factors that it was virtually impossible for a tax practitioner to advise for or against the formation and use of a device which found its way into the law as a device employed by high bracket taxpayers to climb down the surtax ladder. It finds its justification in the fact that a taxpayer can employ any legal method in order to minimize his tax burden.

It was with this confusion in mind that the First Session of the 82nd Congress undertook to clear the smoke and formulate some ground rules which could clear the way for the use of the family partnership device. The lead sentence in the Senate committee reports which accompanied the Revenue Act of 1951 best illustrate the intent: (S. Rept. No. 781, 82nd Cong. 1st Sess; C.B. 1951-2 p. 458 at p. 485)

> "Section 339 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnerships with those generally applicable to other forms of property or business."

The fact that the family partnership resulted in a tax saving was supposedly nondeterminable. There is no question that this case comes within the amendments made by Congress to the 1939 Revenue Act by Section 340(a) and (b) of the Revenue Act of 1951. The only question is the effect of the provision when applied to the facts herein.

ARGUMENT

Argument on Specification of Error Number I.

Congress in order to harmonize the rules governing interest in so-called family partnerships enacted Section 340 (a) and (b) of the Internal Revenue Act of 1951. This section amended Section 3797 (a) (2) of the Internal Revenue Code of 1939, which defines partnerships to include the following:

> "A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."

In addition to the above, the Reveune Act of 1951 added a new section (Section 191 of the Internal Revenue Code of 1939) which provided as follows:

"In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. . . ."

In the instant case, the Tax Court of the United States after recognizing the applicability of the 1951 Revenue Act to the instant proceeding found as a fact that the gifts of an interest in the slot machines and other coin-operated amusement devices involved herein and/or the partnership interest to the minor children of Petitioner were not bona fide and the formation of Spiesman & Sons partnership was a sham (T. 182). This is the crux of the Tax Court finding.

The first inquiry is whether the Tax Court of the United States can make such a finding under the changes made to the law by the 1951 Revenue Act. Certainly it must be recognized that if the new law had any effect at all, the Tax Court is not permitted to disregard it in arriving at its ultimate finding.

The Senate Committee on Finance reports accompanying the above bill (S. Rept. No. 781, 82nd Cong., 1st Sess.; C.B. 1951-2 pp. 485) mention two instances where the Courts can inquire into the validity of the arrangement. The report states as follows:

"The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferror purports to have given or sold him. Cases will arise where the gifts or sale is a mere sham. Other cases will arise where the transferror retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of *Helvering v. Clifford* (309 U. S. 351). The same standards apply in determining the bona fides of alleged family partnerships as in determining the fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale."

In its decision, the Tax Court of the United States resolved many of the problems in favor of the Petitioner which might have arisin under the Revenue Act of 1951, i.e., that capital was a material income-producing factor of Spiesman & Sons; that the salary paid to Petitioner was reasonable; (T. 172) that the income received by the children was used for their benefit to buy bonds, stocks, and pay taxes and that none of the said income was used for the support or

living expenses of any of the minor children (T. 174). The only question left for discussion is whether the gifts were bona fide and whether or not the partnership was a sham. The other factors mentioned by the Court and assigned herein as error will await discussion.

The Tax Court erred on the record in finding that the partnership of Spiesman & Sons was a sham. As the committee reports clearly indicate, (see above) the court in arriving at this conclusion must look at events both *before, surrounding* and *subsequent* to the formation of the partnership.

The events before the formation of the partnership clearly indicate that it wasn't a sham and the subsequent events lend much credence to the position taken by the Petitioner's herein on appeal.

It must be remembered that Petitioner and his father were doing business as a partnership when the instant partnership was formed (Ex. 9). The validity of the original partnership is not questioned. The Petitioner and his father first got the idea of a family partnership from an article appearing in a weekly magazine, the U. S. News and World Report (Ex. 8, T. 56, 85). Many pains were taken to check on the validity of this article before the partnership was formed. Petitioner made a special trip to consult an attorney concerning the validity of a family partnership. The attorney sent the Petitioner to the Internal Revenue Service which refused to make any predictions as to the validity of such an arrangement but

gave the Petitioner at that time a copy of the new law for him to read. Petitioner took the copy of the new law and after showing this to his attorney and after explaining to the attorney that slot machines would be used in the parntership, was informed that such partnership would be entirely valid under the tax laws (T. 85, 86). It must be remembered here that slot machines were legal in the State of Idaho during the years involved herein, being recognized by Sec. 50-1503 of the Idaho Code (S.L. 1947, C. 151), now repealed.

After being advised by the attorney that such a partnership would be valid, a partnership was formed. The partnership agreement was duly executed and signed by all the parties (Plaintiff who was the legally appointed guardian of four of the children signed on their behalf) (Ex. 10).

The Tax Court made much of the fact that the partnership agreement contained pencil changes (T. 170, 182). Yet the changes were made to reflect what must have been quite clearly the intent of the parties (T. 65). The changes merely reflected the true facts as established by the records. If the agreement prior to the change were to be taken at its face, Petitioner's father contributed nothing. Yet the uncontroverted facts show that he did own a one-half interest in the machines immediately prior to the time that Spiesman & Sons was formed. Petitioner's father had purchased a half-interest from Petitioner when the original partnership (Spiesman & Spiesman) was formed (T. 120, 121). The penciled changes made on the partnership agreement here involved reflect that.

The Government certainly cannot complain that the agreement couldn't be overcome by parol evidence since it has long been the rule that the parol evidence rule is inapplicable to tax litigation since the Government was not a party to the original agreement and therefore cannot complain. See *Haverty Realty & Investment Co.* (1944) 3 T.C. 161 at page 167.

The change in the partnership agreement only reflected what the record shows as to the true facts, i.e., that Petitioner, his father and minor children, entered into a partnership by contributing capital and equipment to the partnership (T. 69, 70, 83, 92).

The gifts which Petitioner's father made to the partnership were in line with an overall pattern of gift-making which had been undertaken many years earlier by the elderly man for the very valid purpose of reducing the costs of probate (T. 52). It must also be remembered that the original partnership, Spiesman & Spiesman, was never challenged nor has the validity of that partnership ever been at issue.

The partnership agreement contained no restrictions, such as is often the case in these family partnership arrangements, but provided in effect that the parties could withdraw the profits, after the indebtedness had been paid, periodically at either monthly or quarterly intervals. It is important to note that no restrictions in this regard were imposed upon the parties to this proceeding or to the other partners (Ex. 10, pg. 3).

The partnership operation was valid—the salary paid to Petitioner was reasonable—partnership returns were filed each year showing the proper distributive share of the partnership income to each individual partner involved. The record shows that tax returns were filed on behalf of the children, (T. 125) and it must be assumed in the absence of anything contrary that the returns reported the proper distributable share of partnership income since the Respondent did not introduce the individual income tax returns to overcome the testimony of the Petitioner.

The facts surrounding the partnership formation are not indicative of sham. The Tax Court erred in failing to consider any of the above factors or to comment upon certain material factors surrounding events *subsequent* to the taxable years. The subsequent facts, which were not mentioned, point directly to anything but a sham and lend credence to the validity of the gifts and to the partnership involved herein.

For example, the partnership is still in existence (T. 70, 91). The Idaho law held slot machines unconstitutional after December 31, 1953, (T. 181) but in January of 1955 each partner, including the Petitioner's five children, contributed an additional $500 in capital to the partnership (T. 91, 92). The uncontroverted evidence clearly established the fact that as late as August of 1956 the bank account balances in the names of the minor children had not been disturbed. (See Exhibits J. K. L. M. N.) There was no activity in the partnership either by the Petitioner,

Petitioner's father, or the minor children involved herein which would in any way indicate that the transaction was a sham.

Yet the Tax Court on these facts found a sham transaction. The Tax Court does not, however, consider all of the material facts. The facts which the Tax Court did consider are rebuttable.

Congress, when the word "sham" was mentioned, couldn't have had a factual situation such as the instant one in mind when the Revenue Act of 1951 was enacted. If they did and if the Tax Court can arbitrarily find sham, without any evidence that the donor used the proceeds of the partnership for his own purposes, then the 1951 Revenue Act accomplished nothing. True, a sham would exist if the Petitioner had attempted to use the partnership funds allocable to his children for his own benefit in an effort to funnel low surtax money off to himself for his own use.

The Tax Court's finding of fact disposes of any such contention. The Tax Court finds as a fact that the money was used to pay premiums on the insurance policies held by the minor children; to pay income taxes for the minor children; to purchase additional securities for the minor children; or deposited in a separate savings account for each minor child in the Farmers and Merchants Bank of Rockford, Rockford, Washington (T. 174). No contention is made nor did the findings of fact reflect that the Petitioner appropriated any of the children's money for his own use. Nor was the money used for the support, main-

tenance, and education of the children (T. 174). This factor, we believe, is extremely important in the case.

The motive for forming the partnership is not the "touchstone" under the amendments made by the Internal Revenue Code of 1951, supra.

The Committee Reports, referred to above, mention but two instances where a partnership can be disregarded for tax purposes (1) where the donor retains all the incidents of ownership, i.e., the *Clifford* case (Helvering v. Clifford, 309 U. S. 331), and (2) where the gift is a *sham. Sham* is synonymous with false, it implies make believe, a feigned something, an imitation, a counterfeit. See *Words and Phrases,* Vol. 39 at page 197. When used by the Committee it had to mean a false partnership where the donor used the partnership proceeds to his own benefit. Any othetr meaning would render the Revenue Act of 1951 meaningless and the confusion that admittedly existed prior to the partnership changes in the Revenue Act of 1951 would be again running rampant leaving in its wake, confused taxpayers, expensive litigation and crowded court calendars.

The Tax Court, in its ultimate findings, in using the word sham without giving the reasons for so finding has done exactly what it has been forbidden to do by another Circuit Court of Appeals in *Benjamin D. Gilbert v. Commissioner*, (CA-2, 1957) 248 F. 2d 399, remanding T.C. Memo 1956-137. The Second Circuit Court of Appeals in commenting upon a Tax Court finding to the effect that advances were not bona fide debts said:

> "The opinion of the Tax Court only states a conclusion without assigning the reasons therefor. . . . The opinion of the Tax Court does not state the ground upon which its decision rests."

The facts here certainly leave little doubt that the children received the money and that Petitioner, his children and father operated a bona fide partnership that should be recognized for tax purposes.

ARGUMENT ON ASSIGNMENTS OF ERROR Number II(a) to (d), Inclusive.

The Tax Court of the United States, in arriving at its ultimate finding that the partnership Spiesman & Sons was invalid for federal income tax purposes, based said finding upon certain factors which appear erroneous. The Tax Court in so finding failed to give consideration to all of the surrounding circumstance *prior, during,* and *subsequent* to the formation of the partnership. Some of the factors which the Tax Court relied upon are clearly immaterial and others it can be shown are more indicative of a finding that the partnership was valid rather than a finding that the partnership was a sham.

Argument on Assignment of Error II(a).

The Tax Court first commented upon the fact that the partnership agreement contained certain changes which were made subsequent to the formation of the partnership and upon the fact that the partnership agreement is inconclusive as to the ownership of the coin-operated machines, i.e., that the capital accounts of the minor children failed to show any interest in the machines (T. 182, 183).

As has been explained under assignment of error number I, the partnership agreement was changed to clearly reflect the intent of the parties. The parol evidence was clearly admissible, see *Haverty Realty and Investment Co.,* supra, and the Respondent has no evidence with which to controvert the clear intent of the parties. The Tax Court has perhaps best illustrated the unimportance of this point by stating "whether such assets were owned by one or both is immaterial insofar as the children are concerned" (T. 182, 183). The facts however show that the Petitioner's father owned half of the machines and that he gave a portion of his share to the children. The interlineations appearing on the partnership agreement (Ex. 10) fail to overcome the facts of record. As a matter of fact, the Tax Court in commenting upon the partnership agreement failed to point out that the agreement was duly executed and contained no limitations upon the right of the parties to withdraw their distributive share of partnership income. These factors are important to the decision in this case.

Argument on Assignment of Error II(b).

The Tax Court states that the facts do not support the contention that the children were the owners of a one-ninth interest in the machines because no written transfer of title to the machines was made and the partnership returns show the full value of the machines included in Petitioner's capital account and no interest in the machines included in the capital account of any of the children (T. 183).

The facts surrounding the transfer of title to the machines are clear. As pointed out above, there is no question that title to the machines prior to the transfer to the new partnership (Spiesman & Sons) was owned one-half by Petitioner's father (T. 81, 82). Petitioner's father had paid cash for an undivided half interest in the machines when the original partnership was formed and the money which Petitioner received for these machines was put in his personal account (T. 121). The uncontroverted testimony of Petioner's father shows that he gave the children his interest in Spiesman & Sons by signing the partnership agreement (T. 74). The Plaintiff as guardian for the children accepted the gifts (T. 111). Wherein are the facts which support the Court's statement that the children didn't receive the one-ninth intrest? The only reason could be the Tax Court's failure or refusal to recognize the testimony and there is no basis in the record for such assumption. Certainly the testimony of Petitioner and his father has not been impeached.

It would make no difference that there was no written evidence of transfer of title in the machines from Petitioner and his father to the minor children. The partnership agreement itself, however, is sufficient written evidence for this purpose since it must be admitted that the minor children had a one-ninth interest in the partnership and that the Petitioner's father testified he made the gifts by entering into the family partnership here at issue (T. 73, 74). This makes the ownership in the machines conclusive rather than inconclusive as the Tax Court found.

Apparently the Tax Court placed great weight on the fact that the partnership accounting as shown on the tax returns placed the full value of the machines in the capital account of the Petitioner. The only answer to this is that the returns and the accounting from which returns were prepared are wrong. The best evidence is the fact that Petitioner's father owned one-half of the machines and yet the whole value was erroneously shown on the taxpayer's account. This illustrates the fact that such treatment on the returns was clearly erroneous and must be an unfortunate accounting error. In any event, the cases illustrate the fallacy of placing too much emphasis on obvious accounting errors. They certainly couldn't be controlling. In *Sitterding v. Commissioner* (CA-4, 1936) 80 F. 2d 939 rev'g 32 B.T.A. 506, the Court said:

> "Mere bookkeeping entries cannot preclude the Government from collecting its revenues, nor are such entries conclusive upon the taxpayer. The bookkeeping creates nothing, and the question must be decided according to proven and established facts."

As applied here, the proven and established facts are that Petitioner and his father turned over a portion of their interest in the machines to the Petitioner's minor children. A finding of fact contrary to this, based on the erroneous inclusion of all the machines in the Petitioner's capital account on the partnership tax return, is erroneous. The mistake was immaterial and it had no bearing whatsoever on determining the ownership of the machines.

Argument on Assignment of Error II(c).

The Tax Court placed equal weight on the fact that the partnership returns and guardianship accounting showed the withdrawals to the children to be unequal. The partnership income tax returns (Ex's. 5-E, 6-F), however, show equal distributions of partnership income and there is no controversy that the children filed returns picking up this distributable share. The partnership income was equally divided. It makes no difference that unequal amounts were actually withdrawn. The important thing is that the income was distributed to the children equally on the return and that this is the amount, which under the law they would have to report. The clear testimony is that the returns were filed for each year on behalf of the children and the Government certainly failed to introduce anything that would contradict this fact. It is the distributive share of partnership income allocated to each partner which controls the income tax consequence not the amount withdrawn from the partnership. The other important point not mentioned by the Tax Court is the fact that when Petitioner found he was wrong in making unequal withdrawals, he evened up the withdrawals in later years (T. 90, 91).

The unequal withdrawels caused the Tax Court to say that Petitioner's actions in this regard were "the actions of a parent who owned, controlled and distributed his own funds according to his own desires" (T. 184). The greatest refutation of this is that the funds were never used by or for Petitioner. The Tax Court's finding best illustrates this. The money was

used solely for the children. Is this the action of a sham or of a parent who is using the money for his own uses? The Tax Court failed to note that the Probate Court approved the Guardianship Accounting and their finding also refutes the contention that the Petitioner as a parent of the five minor children controlled and distributed *his* own funds according to *his* own desires. The Probate Court disagrees with the Tax Court on this point (Ex. 14).

Argument on Assignment of Error II(d).

The Tax Court opinion concludes by citing *Commissioner v. Culbertson,* supra, and the oft-quoted language used therein (T. 185). Perhaps reference to the tests laid down in the *Culbertson* case is the best evidence that although the 1951 law as cited, supra, is controlling, the Tax Court of the United States in this regard does not recognize it in the instant case (T. 175). The senate committee reports dispose of any argument in the *Culbertson* case as follows:

> "However, the frequency with which the Tax Court, since the *Culbertson* decision, has held invalid family partnerships based upon donations of capital would seem to indicate that, although the opinions often referred to 'intention,' 'business purpose,' 'reality,' and 'control,' they have in practical effect reached results which suggest that an intra family gift of a partnership interest, where the donee performs no substantial service, will not usually be the basis of a valid partnership for tax purposes. We are informed

> that the settlement of many cases in the field is being held up by the reliance of the field officers of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in *Commissioner v. Tower* (327 US 280) and the opinion of the Supreme Court in *Commissioner v. Culbertson* (337 US 733), which attempts to explain the *Tower* decision affords any justification for the confusion is not material—the confusion exists."

The *Culbertson* case was either overruled, or so limited by the changes made in partnership taxation by the Revenue Act of 1951, that it is ineffective as precedent in the instant case. The Committee reports, above, dispel any attempt to revert back to the *Culbertson* rationale. It is that era of confusion that gave birth to the Revenue Act of 1951.

The Tax Court in its opinion keeps eluding to the fact that all facts and circumstances must be considered as is indicated by the committee reports accompanying the 1951 Revenue Act (T. 184). Yet, as has been illustrated, there are a great many material facts in the record that haven't been touched upon or found material enough to enter their way into the Tax Court's finding of fact.

When all the factors "at the time of the purported gifts and during the periods preceding it and following it" are taken into consideration, the instant partnership is valid within the ambit of the Revenue Act of 1951.

ARGUMENT ON ASSIGNMENTS OF ERROR Number III(a) to (c), Inclusive.

The Tax Court of the United States referred in its opinion to three other factors which, though specifically slated to be non determinative (T. 182) in its ultimate finding, are of some importance and bear comment (T. 180-182). The Petitioner submits that the factors mentioned are actually, where properly construed, helpful to the Petitioner's assertion that the partnership involved herein was valid for federal income tax purposes. This argument will be illustrated below.

Argument on Assignment of Error III(a).

The Tax Court mentions the Government's argument that there was no accounting or supervision by the Probate Court during the taxable years here involved (T. 180).

It must be remembered here that Petitioner was the guardian of the four minor children having been so appointed in 1947 more than four years before the formation of the partnership and was appointed guardian of the youngest child, Francis Spiesman, in 1953 (Ex. 11, 12). The Tax Court here states: "We need not, and we do not, here determine whether the filing of a fiduciary of such accountings and reports as are required by state laws is a necessary condition to the recognition of a minor as a member of a partnership." However, although finding that the regulations, referred to by Respondent, which were promulgated in August of 1953 (Regs. 118, 39.191-1) weren't

applicable until after the taxable years involved herein, the court then went on to state that, "We have no doubt, however, that the filing or failure to file such accounting and reports may be considered, as a fact and circumstances following the purported gifts, in determining the bona fides or lack of bona fides of a purported gift or sale, and we have done so in our determination" (T. 180). If the filing or failure to file accounting reports may be considered or is to be considered, then the Tax Court erred in finding that the conduct of the Petitioner herein didn't substantiate the fact that the transaction was bona fide.

Petitioner it is true filed the inventory and accounting late—after the Internal Revenue Service started their investigation (T. 100). Prior to that time, however, Petitioner did not know that the accounting and inventory had to be filed. The Internal Revenue Agent told him it had to be done (T. 100). He wasn't advised by the attorney to do so and he did file on the advice of the Revenue Agent and probate judge (T. 114). Prior to this time, however, the record shows that Petitioner made a proper accounting of the money to himself. The money was used to buy stocks and bonds for the children in their names and Petitioner didn't put himself on the instruments as co-owner (T. 123). When the time did come for the accounting, everything was in order. The first inventory and accounting reflects in effect the action of Petitioner as guardian over the period 1947 to 1953 (Ex. 13).

The Tax Court states as follows:

> "The proper accounting for a ward's estate by a fiduciary is primarily a matter for the state court to determine." (T. 180)

The Probate Court in and for Benewah County, Idaho, approved the Guardianship account and issued an order settling the same (Ex. 13).

The Tax Court says it is up to the State Court and the State Court says the accounting is entirely proper and yet the Tax Court uses this statement as one of the facts in holding the partnership invalid as being a sham. The inventory and accounting—though late—clearly reflect the complete bona fides of the Petitioner's actions. The money was always used for the benefit of the children and this is the touchstone of reality. Should a few mistakes concerning the law made by a layman mitigate against an otherwise perfectly valid bona fide transaction? The children received all of the money and the State Probate Court recognized this fact. The Tax Court of the United States erred in not recognizing this fact as controlling in Petitioner's favor.

Argument on Assignment of Error III(b).

The court next cites Idaho State Law (T. 163, 180, 181). It is here to be noted that the important fact that during the taxable years involved herein, 1951 and 1952, coin-operated devices were perfectly *legal* in the sovereign state of Idaho. The applicable sections were contained in Chapter 15, Title 50 of the

Idaho Code comprising Sections 15-1501 to 1510, inclusive. The Idaho Supreme Court in *State v. Village of Garden City,* (1953) 74 Idaho 513, 265 P. 2d 328, held that the statute laws of 1947, which enacted the sections mentioned above into law, were unconstitutionel since the legislature could not by law circumvent the Idaho constitutional provision against lotteries. The legislature repealed Chapter 15, Title 50, above, in Chapter 62, Idaho Sessions Laws (House Bill No. 20). Such act in section 4 provides as follows:

> "This act shall be in full force and effect on and after January 1, 1954."

The act was approved February 23, 1953.

There can be no doubt that Petitioner herein was operating within the legislative law of Idaho during the taxable years involved in this proceeding.

The Tax Court cites Section 50-1504 of the Idaho law to the effect that no coin-operated amusement device might be operated on any premises except those owned or leased by the licensee, and, further, that no person other than the licensee "may have any legal, equitable, or financial, title or interest in such device, whether by ownership, mortgage, additional sales contract, or otherwise, nor receive any rent or remuneration therefrom or from the operation thereof" (T. 181). Petitioner in this regard testified that the machines were put on the premises of the Gem State Club under an operating agreement that he had with the Gem State Club prior to the formation of the first partnership, (Spiesman & Spiesman (T. 119). The

ucontroverted evidence shows that the policy was to place the license in the name of the location. This, as Petitioner testified, was required by the Internal Revenue Service (T. 115, 116). The law certainly substantiates Petitioner's statements in this regard.

Section 3267 of the Internal Revenue Code of 1939 entitled "Tax on Coin-Operated Amusement and Gaming Devices" provides in part as follows:

> "Every person who maintains for use or permits the use of, on any place or premises occupied by him, a coin-operated amusement or gaming device shall pay a special tax as follows:"

It is clear from this that the federal tax is to be paid by the location for permitting the "use of coin-operated amusement devices on the premises." The Idaho State law had never been passed upon, decided nor has our research indicated that the question was ever presented.

The state law in federal tax matters has never been controlling either for or against the taxpayer or the government. This is true even where no conflict in the two laws appear. What the court said in *Burnet v. Harmel,* (1932) 287 U. S. 103 is indeed pertinent here:

> "State law may control only when the operation of the federal taxing act, by express language or by necessary implication, makes its operation dependent upon the state law."

This principle is clearly recognized by the 9th Circuit Court of Appeals in the much quoted case of *U. S. v. Kintner,* (CA-9, 1954) 216 F. 2d 418, wherein it was said:

> "The Government's contention, based upon the proposition that because, under local law, a corporation is not allowed to practice medicine, the group is not an association, would introduce an element of uncertainty which neither the courts nor the regulations have recognized. Groups which could not engage in certain activities under State law because of their particular structure, or were considered partnerships have been recognized as legitimate 'associations' partaking of corporate character for taxing purposes under federal law.
>
> "It should be added that it would introduce an anarchic element in the federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence."

In summary, the Idaho State Law, referred to above, is in direct conflict with the federal law, so for federal income tax purposes federal law must control. In any event, State law is not determinative on the

question of the validity of a family partnership since State law does not control for federal income tax purposes.

Argument on Assignment of Error III(c).

The Tax Court of the United States in holding that the partnership Spiesman & Sons was invalid, cites as authority its previous decision in *E. C. Ellery,* (1944) 4 T. C. 407. The taxpayer in the *Ellery* case was the owner and operator of slot machines which were *illegal* under the laws of the State of Ohio. In 1939, the taxpayer had pled guilty to an income tax evasion charge and, before he served his sentence, decided to make his wife a partner so that she could run the business while he was away. The Tax Court held that the partnership was invalid and in so holding stated as follows:

> "Since the gift was conditioned on the formation of the partnership and the partnership could not be formed in Ohio because of its illegal purpose, the gift failed at the outset. The gift failed 'because' it (was) expressly or by implication * * * made upon a condition or limited to a purpose, which it failed."

But the Tax Court in the *Ellery* case didn't decide the case on this point. They then went on to say:

> "We have not found it necessary to place this decision squarely on the grounds urged by Respondent that a partnership void by state law because of illegality should not be recognized for tax purposes any more than it is otherwise recognized by the Courts."

The Tax Court thereupon concluded as follows:

> "This is not to deny that there are instances where there is no other feasible solution than to recognize as a partnership for tax purposes that which would otherwise not be so recognized, whether it be because of illegality of the business or incompetence of the parties."

In *Hanson v. Birmingham,* (District Court, Northern Division of Iowa 1950) 92 F. Supp. 33, it was held that a trust could not be a valid partner for federal income tax purposes. The court in so deciding commented at length upon the question of whether a partnership invalid under state law could nonetheless be a valid partner under the federal tax statutes. After citing cases pro and con, the court said:

> "It is not clear from the authorities as to what the rule is wherein a partnership is invalid or not recognized under the local law."

The *Ellery* case is cited therein.

Strangely, the Tax Court itself in *Theodore D. Stern,* (1950) 15 TC 521 apparently distinguished the *Ellery* case when it said:

> "A married woman cannot be a partner under the law of some states and yet she would be recognized as a partner with her husband under the above definition for federal income tax purposes if, for example, they conducted a woman's hat shop in which the wife was even more important and the husband had a 'partnership agreement' under which her interest was 60 per cent. A

trust's distributive share of the net income of a partnership would have to be included in its gross income in many cases, if for no other reason than that there would be no one else to which the income could be lawfully taxed. Cf. *E. C. Ellery,* 4 T.C. 407, 413. The *Fickert* case, supra, is one example, and others can easily be imagined, including a case where trust corpus was used to buy a building to be managed by another under a so-called partnership agreement in which the manager was to receive a salary and a portion of the profits and the trust was to receive interest on its contribution and a share of the profits. If not a partnership under state law, it may still be a joint venture and thus a partnership for present purposes. Thus, even if a trust could not be a partnership under common law, and even though the enlarged definition of a partnership now appearing in Section 3797 may not have been for the express purpose of covering such a situation, nevertheless, it should be used and it has been used for that purpose."

Under the authority cited by the Tax Court (the *Ellery* case), the partnership could be valid for federal tax purposes though not valid for state purposes. Unquestionably, this would have to be the case. However, the big feature that distinguishes the instant partnership case from the cases cited above, and apparently relied upon in part by the Tax Court, is the fact that when the gifts were made here in the instant case and when the partnership was formed and during the operation of the partnership for the taxable years involved herein, the legislature of the State of

Idaho completely sanctioned the use of coin-operated machines. Here is a situation where the Tax Court would have a partnership fail because the State law under which the partnership operated was subsequently held unconstitutional.

The instant case is a factual case involving a family partnership under the 1951 changes made by Congress in the law regarding partnerships and the first time that the Tax Court has had an opportunity to look at the 1951 changes and the act clarifying the whole partnership picture. Under the new law, the Tax Court, in its findings of fact, had to find either that the Pentitioner retained dominion and control under the *Clifford* rationale or that the partnership was a complete *sham.*

In looking over the record, the Tax Court must look at events both *before, during* and *subsequent* to the formation of the partnership. The record does not support a finding of sham since in all instances the transactions were in accordance with clearly defined and established partnership principles.

The *Clifford* rationale could certainly not be controlling since the gifts were completed and the amounts allocated to each child have been religiously preserved for their benefit by the Petitioner herein. The facts just do not support the ultimate finding that the partnership Spiesman & Sons was invalid so far as the five minor children of the Petitioner are concerned.

ARGUMENT ON ASSIGNMENT OF ERROR IV.

Petitioner in his opening statement referred to the fact that the Internal Revenue Service was taxing the entire income of his children back to Petitioner. Petitioner's then counsel stated:

> "One important point, I think, that is very obvious here is that the income the children received was taxed for the year or for the period beginning after December 1, 1951, through 1952, to the father instead of any of it being taxed back to the grandfather, Mr. M. J. Spiesman, Sr." (T. 37)

The Internal Revenue Service in its 90-day letter which advises of the deficiency and the reasons for it, stated as follows:

> ". . . and the earnings of the business, Spiesman & Sons, are primarily attributable to the service of Mathew J. Spiesman, Jr., and your capital contributions, and further, that to no substantial extent are such earnings attributable to either capital or services of any of the said minor children." (T. 20)

No mention was made in the statutory notice of deficiency of the fact that the original gifts were made by the Petitioner and Petitioner's father.

The undisputed facts, however, are quite clear. The original partnership was between Petitioner and Petitioner's father (Ex. 9). Petitioner's father contribuated one-half of the assets of the then partnership

and received a return of one-third of the income (T. 110). This partnership interest and/or the assets owned by the partnership were the subject of the gifts to the children herein. The uncontroverted evidence shows that Petitioner's father made such gifts (T. 74, 87). This has never been controverted nor has any evidence been introduced by the Internal Revenue Service which would indicate that the original partnership between Petitioner and his father was invalid.

Petitioner takes the position herein that the family partnership is valid, but assuming for the sake of argument that it isn't, the problem still remains as to the validity of the action of the Internal Revenue Service and the Tax Court in failing to recognize that Petitioner can be taxed only on the amunt of income which was generated by the gifts which Petitioner had given to the children. Taxing Petitioner on income earned by the children on property given them by another is carrying the family partnership disallowance doctrine a step further than it has ever been carried before.

The Government certainly introduced no evidence to controvert the fact that Petitioner and his father had a valid partnership. The Court didn't comment on Petitioner's argument in the opening statement. The facts support no other conclusion than the validity of the original partnership and the Petitioner submits that regardless of the outcome of this appeal, the amounts taxable to Petitioner must be decreased by the amount allocable to the gifts made by the grandfather to the children.

CONCLUSION

In deciding the instant case adversely to the Petitioner, herein, the Tax Court of the United States failed to recognize the import of the Revenue Act of 1951. In addition the Tax Court failed to give full consideration to the facts of record both *befor, during* and *subsequent* to the formation of the partnership. The facts of record—when they are all considered—support the Petitioner's contention herein that the partnership Spiesman & Sons was valid for federal income tax purposes.

Respectfully submitted,

PAUL CASTOLDI,
FRANCIS J. BUTLER,
Attorneys for Petitioner.